

## ISSUE

Will an organization exempt from federal income tax under section 501(c)(12) of the Internal Revenue Code jeopardize its exempt status in the taxable year in which it engages in the transaction described below?

## FACTS

The organization's primary purpose is to generate and transmit electricity to its members on a cooperative basis. Its gross receipts from the sale of electricity to members usually represent the organization's only receipts.

In the process of producing electricity the organization regularly uses large quantities of natural gas as fuel to operate its generators. In order to guarantee itself an adequate supply of natural gas in the event of a fuel shortage, the organization entered into a contract with a commercial gas supplier to purchase approximately 500x dollars worth of natural gas during the taxable year. However, the organization estimates that in ordinary operations, assuming no fuel shortage occurs, it will only use approximately 200x dollars of the gas it contracted to purchase. Therefore, the organization entered into a second contract with a commercial pipeline company whereby the pipeline company would buy any excess gas at cost. The pipeline company is not a member of the organization and purchases no electricity from it.

In the taxable year under consideration no fuel shortage occurred and the organization only used 200x dollars worth of the gas it originally estimated. Consequently, pursuant to its contract with the pipeline company, it sold the excess natural gas at cost receiving approximately 300x in gross receipts from the sale.

## LAW AND ANALYSIS

Section 501(c)(12) of the Code provides for the exemption from federal income tax of benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations; but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses.

Rev. Rul. 65-99, 1065-1 C.B. 242, holds, in part, that the 85 percent income requirement of section 501(c)(12) of the Code is applied on the basis of annual accounting periods.

The question presented is to what extent, if any, the gross receipts from the sale of the natural gas to the pipeline company should be taken into consideration in determining whether 85

percent or more of the organization's income consists of amounts collected from members for the sole purpose of meeting losses and expenses, in the taxable year in question. The answer to this question depends upon the meaning of the term 'income' as used in section 501(c)(12) of the Code. Though the term is not specifically defined in that section, or in the Income Tax Regulations thereunder, there is precedent as to its meaning for purposes of the 85 percent member income requirement.

Rev. Rul. 74-362, 1974-2 C.B. 170, states, in part, that compliance with the 85 percent member-income requirement by an organization that is exempt under section 501(c)(12) of the Code is based on 'gross income.' Thus, for purposes of determining whether 85 percent or more of its income is collected by the organization from members for the sole purpose of meeting losses or expenses, the term 'income' means 'gross income.'

Gross income is generally considered to represent an intermediate figure between gross receipts and net income. There are two categories of adjustments from gross receipts that must be taken into consideration in arriving at gross income. These are: 1) trade discounts, allowances on goods sold and refunds on returned goods, and 2) cost of goods sold. In the case of an organization selling merchandise, the cost of goods sold generally is the more significant figure in determining gross income.

While the Code does not specifically allow the deduction for cost of goods sold, section 1.61-3(a) of the Income Tax Regulations provides that in a manufacturing, merchandising, or mining business, 'gross income' means total sales less cost of goods sold. Similarly, in the case of the sale of merchandise by an organization exempt under section 501(c)(12) of the Code, the cost of goods sold should be subtracted from gross receipts in determining whether 85 percent or more of its income has been collected from members for the sole purpose of meeting losses and expenses. This principle applies to both the sale of merchandise in the ordinary course of business, and to the incidental sale of excess supplies or fuel.

Rev. Rul. 68-620, 1968-2 C.B. 199, holds, in part, that gas is generally considered to be inventorable merchandise. See also Rev. Rul. 78-352, 1978-2 C.B. 168. Consequently, even though the sales of gas by this organization is merely ancillary to its primary purpose of providing electricity to its members, the cost of the gas sold should be taken into consideration in determining the amount of gross income derived from the sale.

#### HOLDING

Since the organization is selling the excess gas at cost, there would be no gross income derived from its sale. Thus, in a year in which the organization's only income is from the sale of electricity to its members and from the sale of its excess gas at a price equal to its cost, the organization's only income for

purposes of determining compliance with the 85 percent member-income requirement would be that derived from the sale of electricity to its members. Accordingly, the transaction would not adversely affect the exempt status of the organization under section 501(c)(12) of the Code in the taxable year in which the transaction takes place.